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Banking crises and politics: A long run perspective

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Are the policy responses to the financial crises of 2007-9 and the political events that followed them exceptional? We show that over the course of nearly 150 years, severe banking crises have become increasingly consequential for policy and politics in democracies. First, governments have come much more likely over time to opt for extensive bailouts and other policies aimed at wealth protection during crises. Second, the inclination of voters to punish governments that are in office when crises occur has also increased sharply over time. We argue that the main cause of these developments is the rise of 'great expectations' among large segments of society in modern democracies regarding the protection of wealth in the post-1945 era, especially since the 1970s. From this time, severe banking crises returned as an important threat to this wealth, resulting in rising 'mass pressure from below' on governments to provide costly bailouts and with increasingly powerful political effects.

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Banking crises and politics: a long-run perspective

JEFFREY CHWIEROTH AND ANDREW WALTER

Nearly a decade after a massive crisis engulfed the financial systems of the North Atlantic region, western societies continue to experience political instability, polarization and 'populism'. Voters are apparently 'angry', distrustful of political and policy elites, and inclined to deliver outcomes that many judged unlikely only a decade ago.[1] Institutions and policy norms that looked stable and deeply entrenched before 2007 now seem fragile, including those associated with democracy itself.[2] These developments arguably have roots that precede the financial crises of 2007–2009.[3] What seems incontestable, however, is that these crises unleashed a sustained period of increased political turmoil and rising contestation over economic policy.

This paper adopts a long-run perspective to assess whether these political and policy developments are unusual and exceptional, or whether they are part of a historical pattern. We argue that over the course of nearly 150 years, severe banking crises have become increasingly consequential for policy and politics, and that there are dynamic trends in the way that democracies respond to and are shaped by such crises. First,

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[1] Ronald Inglehart and Pippa Norris, *Trump, Brexit, and the rise of populism: economic have-nots and cultural backlash*, SSRN Scholarly Paper (Social Science Research Network, July 2016); Kenneth Roth, 'The dangerous rise of populism: global attacks on human rights values', in *Human Rights Watch World Report 2017* (New York: Human Rights Watch, 2017), pp. 1–17.

[2] Larry Diamond, Marc F. Plattner and Christopher Walker, *Authoritarianism goes global: the challenge to democracy* (Baltimore : Johns Hopkins University Press, 2016); Roberto Stefan Foa and Yascha Mounk, 'The democratic disconnect', *Journal of Democracy* 27: 3, July 2016, pp. 5–17; Roberto Stefan Foa and Yascha Mounk, 'The signs of deconsolidation', *Journal of Democracy* 28: 1, Jan. 2017, pp. 5–15.

[3] Thomas Piketty and Gabriel Zucman, 'Wealth and inheritance in the long run', in Anthony B. Atkinson and François Bourguignon, eds, *Handbook of income distribution* (Amsterdam: Elsevier, 2015), pp. 1303–68; Neil Postman, *Amusing ourselves to death: public discourse in the age of show business* (London: Methuen, 1987).

governments have become much more likely over time to opt for extensive bailouts and other policies aimed at wealth protection during crises. Second, voters have become much more likely to punish incumbent governments when crises occur.

The main reason for these developments, we suggest, is that large segments of society in modern democracies came to demand that governments provide protection from economic downturns and the especially sharp shocks associated with severe financial crises—to have, that is, what we term 'great expectations'. At first, in the wake of the Great Depression and the Second World War, this demand was focused on the need to avoid deep banking crises of the kind that occurred in the early 1930s, and on the need to ensure full employment and growth in incomes.[4] In the period from about 1945 to 1970, these demands were met by varying mixtures of extensive administrative controls on financial activity, Keynesian demand management, and industrial and wages policies associated with 'embedded liberalism'. As the costs of these policies became increasingly apparent by the 1970s, a new set of policy ideas emerged that expounded the benefits of moving away from macroeconomic activism and towards the liberalization of markets and finance.[5] In part as a consequence of the financial liberalization that followed, banking crises re-emerged as an important policy challenge and as a threat to rising societal wealth from the mid-1970s. Growing 'pressure from below' to protect this wealth helps to explain both the increased propensity for government bailouts and the increasingly powerful political effects of these crises.

Our argument, elaborated in more detail below, consists of four novel elements. First, it demonstrates the central importance of changing societal norms regarding government policy responsibilities, specifically the reorientation of societal demands from the previously dominant focus on income and employment protection in the era of embedded liberalism to the protection of accumulated wealth. Second, it underlines

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[4] Karl Polanyi, *The great transformation* (Boston: Beacon, 1967; first publ. 1957); John Gerard Ruggie, 'International regimes, transactions, and change: embedded liberalism in the postwar economic order', *International Organization* 36: 2, April 1982, pp. 379–415.

[5] Mark Blyth, *Great transformations: the rise and decline of embedded liberalism* (New York: Cambridge University Press, 2002).

the limits of democratic accountability in lowering the propensity to undertake bailouts. Third, it suggests that domestic political institutions acquired increased importance for voters primarily because they shape how governments undertake policy responses to crises. And finally, it provides political reasons why developed democracies generate endogenous tendencies to financial instability.

The next section elaborates briefly on our claims concerning the rise and evolution of great expectations. The following section summarizes our argument about the consequences of this evolution for policy and politics during and after severe banking crises. The third section assesses the evidence for this argument and the final section considers its broader implications.

The rise of great expectations: three eras since 1870

To clarify our argument about the rise and evolution of great expectations, we divide the period since 1870 into three eras. This periodization is guided by our emphasis on the importance of rising societal wealth and changing societal expectations of policy and political outcomes. In the first era, from about 1870 until the Great Depression, there was a low level of effective societal demand for economic protection in democracies, reflected for example in the very low levels of social welfare provision by the state compared to those of the post-1945 era.[6] Elites connected to insolvent financial institutions often requested government rescues in this period, but with little mass pressure from below governments typically responded to banking crises in ways that were relatively 'market-conforming'. Governments on occasion extended support to distressed financial institutions, but there was no systematic or widespread protection of banks and their creditors.[7]

The disastrous consequences of such policies, notably in the United States and parts of continental Europe, were demonstrated in the Great Depression and its aftermath. In the second era, after 1945, societies in many countries wanted far greater assurance

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[6] Asa Briggs, 'The welfare state in historical perspective', *European Journal of Sociology* 2: 2, 1961, pp. 221–58.

[7] Charles Arthur Conant, *A history of modern banks of issue*, 5th edn (New York: Putnam, 1915).

regarding employment, incomes, and economic and social protection generally.[8] Governments were, however, more ambiguously committed to the protection of wealth. This was largely assured in practice in the early postwar decades: for the most part, banks didn't fail, deposits appeared safe, house prices were (by recent standards) relatively stable, pensions accumulated in defined benefit schemes, and currencies were largely fixed.[9] On the other hand, in some ways most advanced democratic countries focused on the *suppression* and redistribution of wealth: postwar marginal tax rates on the wealthiest peaked after the war and remained high until the 1970s.[10] Financial repression was also extensive until the 1970s, when pressure for liberalization accelerated.[11]

The third era, from the mid-1970s, was one in which financial liberalization was combined with new forms of financial regulation. A move towards more market-oriented financial policies would, it was hoped, restore more rapid growth. It certainly produced a continued rise in the value of housing and financial assets in many countries, as well as greater instability in their values. Figure 1 reveals the sharp rise in real net private wealth per capita in a number of advanced countries after 1970. Much of the wealth that has been accumulated by the middle classes has been in the form of housing equity and pension assets, with the latter held increasingly in defined contribution schemes.[12] As some authors have argued, this 'wealth' can have a darker

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[8] Ruggie, 'International regimes, transactions, and change'; G. John Ikenberry, 'A world economy restored: expert consensus and the Anglo-American postwar settlement', *International Organization* 46: 1, 1992, pp. 289–321; Blyth, *Great transformations*; Polanyi, *The great transformation*; Briggs, 'The welfare state in historical perspective'.

[9] Robert J. Shiller, *Irrational exuberance* (Princeton: Princeton University Press, 2005).

[10] Kenneth Scheve and David Stasavage, *Taxing the rich: a history of fiscal fairness in the United States and Europe* (Princeton and Oxford: Oxford University Press, 2016).

[11] Eric Helleiner, *States and the reemergence of global finance: from Bretton Woods to the 1990s* (Ithaca, NY: Cornell University Press, 1994).

[12] Piketty and Zucman, 'Wealth and inheritance in the long run'.

side when it is associated with a rising need for households to purchase expensive services such as education and healthcare.[13] One indication of the extent of this shift over the long run is provided by the rate of owner-occupation in housing, which increased in Britain from about one-fifth to more than two-thirds of households over the course of the twentieth century.[14] Similar trends occurred elsewhere.[15]

<figure 1 here>

As societal wealth grew rapidly in advanced countries, the threat of banking crises became significant once more. This intensified the demand for wealth protection that had always been implicit in the postwar system. In the next section, we discuss how governments have responded.

The consequences of great expectations

We argue that this growing demand 'from below' for the protection of wealth has had crucial economic, policy and political consequences in democracies that distinguish this second era from the first. We focus on two here. First, when banking crises do occur, most governments are now subject to increasing pressure from a much wider political coalition to provide decisive bailouts to prevent extensive destruction of jobs and wealth. Second, governments that fail to provide such bailouts, or do so in a manner that is delayed or substantially redistributive, tend to be punished far more than in the pre-1945 era. We also argue that, perhaps more surprisingly, in an age of

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[13] Paul Langley, *The everyday life of global finance: Saving and borrowing in Anglo-America* (Oxford: Oxford University Press, 2008).

[14] Office for National Statistics, *A century of home ownership and renting in England and Wales*, UK Government Web Archive (London: The National Archives, 19 April 2013), http://webarchive.nationalarchives.gov.uk/20160105160709/http://www.ons.gov.uk/ons/rel/census/2011-census-analysis/a-century-of-home-ownership-and-renting-in-england-and-wales/short-story-on-housing.html. (Unless otherwise noted at point of citation, all URLs cited in this article were accessible on 20 June 2017.)

[15] *United Nations Human Settlements Programme 2005 Annual Report*, *ReliefWeb*, 1 June 2006, http://reliefweb.int/report/world/united-nations-human-settlements-programme-2005-annual-report.

great expectations, even when incumbent governments do respond to crises by intervening to prevent economic and financial collapse, they are still much more likely to suffer greater electoral punishment than in the past.

A rising demand for bailouts

In a low-expectations world, such as that of our first era, the political constituency favouring minimal public intervention in crises is likely to dominate the constituency favouring public-sector support of failing banks. Minimal, 'market-conforming' interventions in principle provide emergency support at market interest rates only to banks that are solvent and would survive in normal circumstances: these are what Guillermo Rosas summarizes as 'Bagehot' policies.[16]

In the kind of high-expectations world that has emerged since the 1970s, by contrast, more voters will favour policy interventions that minimize the potential damage to their employment, income and wealth—with the proviso, as we argue below, that these interventions do not have adverse distributional consequences. Such 'bailouts' work against market forces if the government acts to prevent or absorb losses by actual or potentially insolvent banks, and mitigates sharp falls in employment, incomes and asset values that could affect a large number of other actors, including households and non-financial firms.

The main constituencies favouring limited, Bagehot-style policy responses in crises are taxpayers, solvent banks, the employees, creditors and debtors linked to these banks, and public-sector workers and welfare beneficiaries who wish to preserve their share of and access to public expenditure. On the other side, the constituency favouring public bailouts comprises insolvent banks, along with the depositors, creditors, investors, debtors and employees associated with such banks, and highly leveraged actors who stand to lose most from a depreciation of asset prices. Our claim is that the comparative size and influence of the pro-bailout constituency increased substantially after the 1970s, and especially from the 1990s. There are two main, interconnected reasons for this: financialization and the democratization of leverage. Both must be understood as long-run, evolutionary processes.

[16] Guillermo Rosas, *Curbing bailouts: bank crises and democratic accountability in comparative perspective* (Ann Arbor: University of Michigan Press, 2009), pp. 6–7.

John Kay describes *financialization* as a process of deepening and increasing financial complexity, characterized by 'the substitution of trading and transactions for relationships, and the [associated] restructuring of finance businesses'.[17] Banks have become steadily more important in modern economies as facilitators of the payments system, as brokers who match lenders with borrowers, and as managers of other actors' savings and financial risk. This raises the potential for systemic risk in the financial system, or 'the risk that the inability of one or more participants to perform as expected will cause other participants to be unable to meet their obligations when due'.[18]

This system complexity fosters greater fragility, which in turn increases the interest of various actors formerly associated with the Bagehot coalition in favouring government action to prevent failures at any point in the system. Solvent banks, for example, may not be safe if failures elsewhere in the system lead to widespread asset price depreciation and if funding markets collapse, as occurred in September 2008. Thus, other actors with interests in large, complex banks also now favour public bailouts even of insolvent institutions—as the case of the insurer AIG in 2008 demonstrated. Standing behind these actors were the many middle-class households with savings in money-market and investment funds and housing equity leveraged by mortgage finance. Although interconnections among banks were also present before the Second World War, their scope and magnitude were of a much smaller scale, and requests for bailout interventions often fell on deaf ears. As late as the early 1930s, German and American authorities stood by as large parts of their banking sector collapsed.

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[17] John A. Kay, *Other people's money: masters of the universe or servants of the people?* (London: Profile, 2015). See also Greta R. Krippner, 'The financialization of the American economy', *Socio-Economic Review* 3: 2, May 2005, pp. 173–208; Andrew G. Haldane and Robert M. May, 'Systemic risk in banking ecosystems', *Nature* 469: 7330, Jan. 2011, pp. 351–5.

[18] Bank for International Settlements, Committee on Payments and Market Infrastructures, 'Glossary', 16 June 2015, http://www.bis.org/cpmi/publ/d00b.htm?&selection=68&scope=CPMI&c=a&base=term.

Such policy stances became unthinkable after the ensuing experience of depression and war. When banking crises returned as significant threats to savings after the 1970s, governments responded by providing more explicit and more generous deposit insurance schemes.[19] Even more consequentially, the growth of housing equity and the move towards defined contribution pension schemes have increased households' stake in the stabilization of the market value of a much broader class of underlying financial assets.[20] Since 'systemic' banks and other financial institutions[21] are so closely involved in the financing, management and trading of housing and financial assets, the stake of the middle classes in the protection of these firms has grown.

Mortgage lending grew rapidly over the course of the twentieth century, facilitating what Jordà, Schularick and Taylor refer to as the 'democratization of leverage': 'Nearly all of the increase in the size of the financial sectors in Western economies since 1913 stems from a boom in mortgage lending to households and has little to do with the financing of the business sector.'[22] The result has been rising household sector leverage and greater financial fragility.[23] The dependence on leverage to

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19 Christopher Gandrud, 'Competing risks and deposit insurance governance convergence', *International Political Science Review* 35: 2, March 2014, pp. 195–215.

20 Sarah M. Brooks, 'When does diffusion matter? Explaining the spread of structural pension reforms across nations', *Journal of Politics* 69: 3, Aug. 2007, pp. 701–15; Organisation for Economic Cooperation and Development, *Pensions at a glance 2015: OECD and G20 Indicators*, 2015, http://www.oecd.org/publications/oecd-pensions-at-a-glance-19991363.htm.

21 Those whose failure would threaten the stability of the whole financial system.

22 Oscar Jordà, Moritz Schularick and Alan M. Taylor, 'The great mortgaging: housing finance, crises and business cycles', *Economic Policy* 31: 85, Jan. 2016, pp. 107–40.

23 Charles A. E. Goodhart and Philipp Erfurth, 'Monetary policy and long-term trends', *VoxEU.org*, 3 Nov. 2014, http://voxeu.org/article/monetary-policy-and-long-term-trends; Òscar Jordà, Moritz Schularick and Alan M. Taylor, 'Leveraged bubbles', *Journal of Monetary Economics* 76, supplement, Dec. 2015, pp. 1–20; Jordà et al., 'The great mortgaging'.

acquire housing assets has been particularly marked in countries experiencing house-price booms and increasing inequality.[24] As Ansell points out, this has had important consequences for individual social policy preferences.[25] We suggest that it has also meant that households in developed and many developing countries have acquired a much greater interest in the maintenance of the flow of credit than was the case before the Second World War.

Although taxpayers, public-sector workers and welfare beneficiaries have also increased in number since 1945 and might have an interest in resisting costly bailouts, they are relatively weak sources of support for Bagehot policies. First, the costs of bailouts are widely distributed among these groups, who will often find it difficult to organize collectively.[26] By contrast, the benefits reaped by the beneficiaries of bailouts are highly concentrated, as are the costs that Bagehot policies impose on them. Second, the full costs of bailouts may materialize only after considerable delay, and potential opponents will often lack strong incentives to mobilize against potentially costly bailouts at the time they are undertaken. Third, taxpayers and public-sector beneficiaries are also employees, consumers and (sometimes) firms: real-world actors have composite interests, diluting their incentives to act collectively to limit their tax liabilities or to maximize their share of public spending. Fourth, elites may be able to deflect potential opposition to bailouts by claiming that extensive intervention today will minimize larger public revenue and welfare losses

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[24] Robert H. Frank, *Falling behind: how rising inequality harms the middle class* (Berkeley: University of California Press, 2013), ch. 5; Avner Offer, 'Narrow banking, real estate, and financial stability in the UK, 1870–2010', in Nicholas Dimsdale and Anthony Hotson, eds, *British financial crises since 1825* (Oxford: Oxford University Press, 2014), pp. 158–73; Raghuram Rajan, *Fault lines: how hidden fractures still threaten the world economy* (Princeton: Princeton University Press, 2010).

[25] Ben Ansell, 'The political economy of ownership: housing markets and the welfare state', *American Political Science Review* 108: 2, 2014, pp. 1–20.

[26] Rosas, *Curbing bailouts*, p. 8.

tomorrow.[27]

For all these reasons, we believe, there has been steadily growing and increasingly widespread demand for bailouts during financial crises. To our knowledge there are no cross-national longitudinal survey data on voter attitudes towards wealth protection. However, two national household surveys, in the Netherlands in 2010 and in the United Kingdom in multiple waves from 2003 to 2012, suggest that the Dutch and British publics have high expectations of regulators and supervisors and a dominant expectation that governments will opt for bailouts and other policies aimed at wealth protection during crises.[28] In Britain these expectations persisted despite repeated efforts by the financial regulator over this period to articulate a 'non-zero-failure' regime. Also, cross-country surveys do *not* indicate any overall rise in average support for greater government responsibility in other aspects of life, suggesting that the rising demand for government wealth protection is atypical.[29]

Our argument does not make strong assumptions about voter rationality. Although most voters will find it difficult to understand the intricacies of increasingly complex financial systems, even unsophisticated voters can understand losses, or the threat of losses, to their most important asset holdings. Psychologists have shown that individuals are in fact unusually sensitive to even minor transactional losses as well as

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[27] Two prominent recent examples were statements by British Prime Minister Gordon Brown and US President George W. Bush in late 2008 justifying bank bailouts by emphasizing the need to protect households and the broader economy from a financial collapse. See 'President Bush's speech to the nation on the economic crisis', transcript, *New York Times*, 24 Sept. 2008, and Gordon Brown's remarks in Hansard (Commons), 29 Jun 2009: Column 21.

[28] Carin Van der Cruijsen, Jakob de Hann, David-Jan Jansen and Robert Mosch, 'Knowledge and opinions about banking supervision: evidence from a survey of Dutch households', *Journal of Financial Stability* 9: 2, 2013, pp. 219–29; Financial Services Authority, *Consumer awareness of the FSA and financial regulation* (London, 2012).

[29] Authors' analysis of the World Values Survey data on government responsibility (E037) for 1981–2014, http://www.worldvaluessurvey.org/WVSDocumentationWVL.jsp.

to perceptions of unfair treatment.[30]

Nor, as we elaborate in the next section, do we assume that governments automatically aggregate and respond to changing voter preferences. However, we do suggest that democratically elected governments, by virtue of electoral accountability and legitimacy imperatives, face at least some incentive to implement the dominant policy preferences of voters as they try to prevent and manage banking crises. This argument is consistent with a range of scholarship in related fields,[31] and with literature showing considerable congruence between changes in public opinion and in policies across a range of issue areas.[32] If, as we argue, households with growing wealth portfolios share an interest in wealth protection regardless of their partisan values, governments of both left and right should be increasingly inclined to provide bailouts in response to these constituency interests.

A rising tendency for political punishment

The fact that demand for bailouts has risen does not necessarily mean that all elected governments will provide them. Political institutions aggregate interest-group preferences, but they also reshape and sometimes block them. Many authors have highlighted the ability of polarized veto players to frustrate voter expectations

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[30] Daniel Kahneman and Amos Tversky, 'Choices, values, and frames', *American Psychologist* 39: 4, 1984, pp. 341–50.

[31] Robert Barro, 'The control of politicians: an economic model', *Public Choice* 14: 1, 1973, pp. 19–42; John Ferejohn, 'Incumbent performance and electoral control', *Public Choice* 50: 1/3, 1986, pp. 5–25; Douglas C. North and Barry Weingast, 'Constitutions and commitment: the evolution of institutions governing public choice in seventeenth-century England', *Journal of Economic History* 49: 4, 1989, pp. 803–32; Kenneth Schultz and Barry Weingast, 'The democratic advantage: institutional foundations of financial power in international competition', *International Organization* 57: 1, 2003, pp. 3–42; Leonard Seabrooke, 'The everyday social sources of economic crises: from great frustrations to great revelations in interwar Britain', *International Studies Quarterly* 51: 4 , 2007, pp. 795–810.

[32] e.g. Benjamin I. Page and Robert Y. Shapiro, 'Effects on public opinion on policy', *American Political Science Review* 77: 1, 1983, pp. 175–90.

regarding government policies.[33] Others argue that banking crises increase the level of political polarization because of their actual or potential distributional impact.[34] A large negative economic shock from a crisis may also reconfigure prior voter beliefs about appropriate policy, increasing ideological fragmentation.[35] If crises increase polarization and produce policy gridlock, incumbent governments may find it difficult to respond in the way that most voters expect.[36] This is most likely to happen when polarized actors have access to institutional vetoes. Policy gridlock that delays or prevents adequate intervention can also generate spikes in risk premiums in sovereign debt markets, which can trigger debt crises, delay recoveries and amplify voter

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[33] Alberto Alesina and Allan Drazen, 'Why are stabilizations delayed?', *American Economic Review* 81: 5, 1991, pp. 1170–88; Adriana Crespo-Tenorio, Nathan M. Jensen and Guillermo Rosas, 'Political liabilities: surviving banking crises', *Comparative Political Studies* 47: 7, 1 June 2014, pp. 1047–74, p. 9; George Tsebelis, *Veto players: how political institutions work* (Princeton: Princeton University Press, 2002).

[34] Manuel Funke, Moritz Schularick and Christoph Trebesch, 'Going to extremes: politics after financial crises, 1870–2014', *European Economic Review* 88: C, 2016, pp. 227–60; Atif Mian, Amir Sufi and Francesco Trebbi, 'Resolving debt overhang: political constraints in the aftermath of financial crises', *American Economic Journal: Macroeconomics* 6: 2, April 2014, pp. 1–28; Anthony B. Atkinson and Salvatore Morelli, *Economic crises and inequality*, Human Development Research Paper 2011/06 (New York: UN Development Programme, 2011); Michael D. Bordo and Christopher M. Meissner, *Does inequality lead to a financial crisis?*, working paper (Cambridge, MA: National Bureau of Economic Research, March 2012).

[35] Blyth, *Great transformations*.

[36] Stephan Haggard, *The political economy of the Asian financial crisis* (Washington, DC: Institute for International Economics, 2000); Stephan Haggard and Robert R. Kaufman, *The political economy of democratic transitions* (Princeton: Princeton University Press, 1995); Shanker Satyanath, *Globalization, politics, and financial turmoil: Asia's banking crisis* (New York: Cambridge University Press, 2006); Thomas Oatley, 'Why is stabilization sometimes delayed? Reevaluating the regime-type hypothesis', *Comparative Political Studies* 37: 3, April 2004, pp. 286–312.

discontent and polarization.[37]

In a low-expectations world, in which most voters do not see governments as responsible for preventing crises and mitigating their impact, this will matter less. In a high-expectations world, policy gridlock is likely to be highly consequential because a failure to meet the heightened expectations of voters is likely to result in severe electoral punishment.

Our argument differs from the 'clarity of responsibility' literature on economic voting, which suggests that veto dispersal means voters find it difficult to assign blame to incumbent governments for suboptimal policy choices that produce downturns.[38] We do not expect most voters to be forgiving of incumbent governments whose hands are 'tied' by polarized institutional vetoes, because of the intensity of the demand for wealth protection and because of the informational disadvantage of most voters. Most voters will find it difficult to discern how much a bad policy outcome is the result of institutional constraints, leadership choice or simple incompetence.[39] Thus, we argue that changing societal expectations of government policy have also altered the way in which institutional variations across democratic countries matter for the survival prospects of incumbent governments.[40]

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[37] Mian et al., 'Resolving debt overhang', p. 26.

[38] Raymond M. Duch and Randolph T. Stevenson, *The economic vote: how political and economic institutions condition election results* (New York: Cambridge University Press, 2008); Timothy Hellwig and David Samuels, 'Voting in open economies: the electoral consequences of globalization', *Comparative Political Studies* 40: 3, March 2007, pp. 283–306; G. Bingham Powell and Guy D. Whitten, 'A cross-national analysis of economic voting: taking account of the political context', *American Journal of Political Science* 37: 2, 1993, pp. 391–414.

[39] Andrew Healy and Neil Malhotra, 'Retrospective voting reconsidered', *Annual Review of Political Science* 16: 1, 2013, pp. 285–306 at p. 6.

[40] The same logic could be applied to "external constraints" on crisis policy responses, such as financial openness or IMF conditionality, which some argue can also blur perceptions of government responsibility during banking crises: see Crespo-Tenorio et al., 'Political liabilities'.

Our argument does not imply that voters will *reward* governments who do respond to crises with bailouts. On the contrary, we doubt that this kind of symmetry will operate. First, the occurrence of a crisis is a reasonable indicator for informationally constrained voters of policy incompetence, a failure to prevent a substantive threat to something about which voters now care deeply. Second, even when banking crises are accompanied by extensive bailouts and macroeconomic stimuli, they generally result in deep and long recessions and sharp falls in asset prices.[41] In democracies, such losses give political oppositions opportunities to portray policy interventions as delayed, partisan, misjudged or simply inadequate.

A third reason why informationally constrained voters will be inclined to punish governments even when bailouts are forthcoming is that these often have powerful adverse distributional consequences. Although individual voters are likely to be most concerned about their potential to suffer absolute losses, there is considerable evidence that they are also sensitive to *relative* losses and attached to norms of fairness.[42] Bank bailouts have contributed to widespread perceptions that large financial institutions have 'captured' politics and policy.[43] Creditor bailouts have sown fears that interventions will incentivize risky future lending. Debtor bailouts—such as government attempts to rescue highly leveraged households—are often resisted by those who object to 'society' bearing the costs incurred by irresponsible

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[41] Michael Bordo, Barry Eichengreen, Daniela Klingebiel and Maria Soledad Martinez- Peria, 'Is the crisis problem growing more severe?', *Economic Policy* 16: 32, April 2001, pp. 52–82; Carmen M. Reinhart and Kenneth S. Rogoff, *This time is different: eight centuries of financial folly* (Princeton: Princeton University Press, 2009); Jordà et al., 'Leveraged bubbles'.

[42] Richard H. Thaler, *Misbehaving: the making of behavioral economics* (New York: Norton, 2015), ch. 15.

[43] Simon Johnson and James Kwak, *13 bankers: the Wall Street takeover and the next financial meltdown* (New York: Pantheon, 2010); Jacob S. Hacker and Paul Pierson, *Winner-take-all politics: how Washington made the rich richer and turned its back on the middle class* (New York: Simon & Schuster, 2010; Pepper D. Culpepper and Raphael Reinke, 'Structural power and bank bailouts in the United Kingdom and the United States', *Politics and Society* 42: 4, Dec. 2014, pp. 427–54.

borrowers. Still others worry that increases in public borrowing and extraordinary monetary expansions risk future inflation.

Specific circumstances could increase such voter perceptions of unfairness. Financialization and the associated growth in the visibility of financial sector compensation in some countries in recent decades compound perceptions that bailouts of large financial institutions rescue the wealthy and influential. It is also possible that governments facing greater institutional constraints will favour selective intervention on terms more favourable to concentrated special interests than to diffuse unorganized groups, compounding perceptions of unfairness.[44]

Governments and central banks generally contest these criticisms on the grounds that without bailouts, employment, incomes and asset prices would fall much more sharply, risking a depression in which most citizens would experience far greater losses. However, we doubt that most voters undertake such considered counterfactual analysis and reward governments for (possibly) ensuring that their losses are lower than they might have been in an alternative, hypothetical world.

To summarize, our argument is that there is a long-run rise in demand on the part of broad sections of society for financial stabilization and for elected governments to provide increasingly extensive bailouts in more highly financialized economies. We argue that this will sharply differentiate both policy outcomes and political consequences in recent decades from those that prevailed in the era before 1945. We expect that governments will respond to this societal pressure 'from below' by providing more extensive bailouts. However, such interventions are still highly contested and governments will often respond with delays and in different ways, depending on a range of economic, institutional and political factors. As a result, great expectations 'lift and tilt' the bar regarding citizen assessments of government performance: voters have become increasingly likely to punish governments heavily for perceived failures to protect their incomes and wealth, while remaining disinclined to reward political incumbents for acting in accordance with these expectations.

This is not quite a case of 'damned if they do, damned if they don't', since the negative consequences for political incumbents of a failure to stabilize the financial

[44] Johnson and Kwak, *13 bankers*; Mian et al., 'Resolving debt overhang'.

system are almost certainly greater, especially in circumstances of extensive financialization. Nevertheless, it is precisely in such circumstances that the electoral rewards are likely to be elusive, because of the visibly high cost of stabilizing large financial firms. Since incumbents' fear of complete financial collapse will generally trump concerns about generating unwanted distributional consequences, this is a cost that most governments will be forced to bear. We return to this political dilemma in the conclusion.

Evidence

In exploring the consequences of the rise of great expectations, we present a series of stylized facts that makes use of a new long-term historical database extending from the mid-nineteenth century to 2015. First, we present evidence, consistent with rising voter pressure, that modern governments have tended to implement more extensive bailouts in the aftermath of financial crises. Second, we show that, in spite of this recent tendency, voters since the 1970s punish incumbents more severely following banking crises, particularly in democracies with more polarized veto players.

Policy responses to banking crises

In this section we explore the post-crisis policy responses of governments since 1848. Our analysis includes government policy responses to 81 systemic banking crises in democratic countries with start dates from 1848 to 2008; 30 crises in the pre-war period, 51 crises after 1970. We use the crisis data from Reinhart and Rogoff (R&R), who provide the most comprehensive data on banking crises since the early nineteenth century, focusing only on those crises they categorize as systemic.[45]

We follow a similar procedure to Rosas, focusing on microeconomic policy responses to banking crises and measuring the overall tendency for governments to depart from a market-conforming, 'Bagehot' policy stance.[46] Rosas counted a number of

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[45] Reinhart and Rogoff, *This time is different;* Carmen M. Reinhart, *This time is different chartbook: country histories on debt, default, and financial crises*, working paper (Cambridge, MA: National Bureau of Economic Research, March 2010).

[46] Guillermo Rosas, 'Bagehot or bailout? An analysis of government responses to banking crises', *American Journal of Political Science* 50:1, Jan. 2006, pp. 175–91.

microeconomic policy measures that can be categorized as either 'Bailout' or 'Bagehot'—measures that taken together either serve to prevent insolvent banks from failing, or alternatively that ensure that losses by such banks are crystallized and borne by their owners, employees and investors.

<table 1 near here>

Table 1 summarizes the elements of our newly constructed policy response index. The first column of the table identifies five crucial policy issue areas: last-resort lending, non-performing assets, bank recapitalization, socialization of liabilities, and exit policy. Entries in the next two columns refer to the policy decisions that characterize a Bagehot or a Bailout response.

We then apply eight binary indicators—*bank liquidity*, *public asset management or debt relief programme*, *recapitalization*, *guarantees*, *deposit insurance*, *deposit freeze*, *deposit loss* and *bank restructuring*—to the relevant policy issue areas, as set out in the fourth column of table 1.[47] We have drawn on various sources to develop the index,[48] and have considered all policy responses that occur within three years after

[47] Rosas, 'Bagehot or bailout?', pp. 185–86, also considers regulatory forbearance as a potential indicator, but finds that it performs poorly in identifying underlying government proclivity towards bailouts. Since most governments are likely to choose forbearance but it is often difficult to detect, we exclude it from our analysis.

[48] Michael Bordo, 'Financial crises database', 2001, https://sites.google.com/site/michaelbordo/home3; Gandrud, 'Competing risks and deposit insurance governance convergence'; Christopher Gandrud and Mark Hallerberg, *When all is said and done: updating 'Elections, special interests, and financial crisis'*, SSRN Scholarly Paper (Social Science Research Network, Nov. 2014); Patrick Honohan and Daniela Klingebiel, *Controlling the fiscal costs of banking crises*, policy research working paper series (Washington DC: World Bank, Sept. 2000); Patrick Honohan and Daniela Klingebiel, 'The fiscal cost implications of an accommodating approach to banking crises', *Journal of Banking and Finance* 27: 8, Aug. 2003, pp. 1539–60; Luc Laeven and Fabián Valencia, *Systemic banking crises: a new database*, SSRN Scholarly Paper (Social Science Research Network, Sept. 2008); Luc Laeven and Fabián Valencia, 'Systemic banking crises database',

the crisis window identified in the R&R database.

Governments often employ a range of responses when responding to crises. For instance, even a very pro-market government may provide extensive liquidity support as it restructures the banking system and closes insolvent banks. Likewise, bailouts involving recapitalizations and guarantees often require closures and mergers of failing banks. Since the raw data do not reveal which indicators are correlated, we use the *first principal component* of the eight indicators as our preferred measure of government policy responses to banking crises.[49] The resulting index ranges from −2.38 to 3.88, with higher values indicating a more coherent set of Bailout policy responses and lower values indicating a more coherent set of Bagehot policy responses.

In a world where governments implement a range of policy responses, principal component analysis informs us how these responses co-vary along the Bagehot–Bailout continuum. Our analysis of this index reveals, in order of importance, that deposit insurance, recapitalization and public asset management are the three key components that most strongly identify Bailout interventions, with bank liquidity and guarantees playing a somewhat weaker part, and deposit freezes having almost no role. Not surprisingly, bank restructuring and deposit losses are more strongly related to a Bagehot response.

Figure 2 plots the number of systemic banking crises and the average crisis policy response in democracies since 1848.[50] We find that before 1945 Bailout interventions

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IMF Economic Review 61: 2, 2013, pp. 225–70; Charles A. Conant, *A history of modern banks of issue* (New York: Putnam, 1902); Conant, *A history of modern banks of issue*, 5th edn; Charles Poor Kindleberger and Robert Z. Aliber, *Manias, panics and crashes: a history of financial crises* (Basingstoke and New York: Palgrave Macmillan, 2011).

[49] For an overview of principal component analysis, see George H. Dunteman, *Principal components analysis* (Newbury Park and London: Sage, 1989).

[50] We define democracies as those with Polity2 scores in the Polity IV dataset of at least 6 in the year the crisis begins, and include only countries with majority adult male enfranchisement, thus aiming to rule out the possibility that our results are

were exceptional, whereas by the 1990s they had become the rule. The average crisis policy response in the prewar period (−1.62 on our index) stands in stark contrast to that in the post-1970 period (0.963). This difference in means attains a high level of statistical significance ($t = 8.911$, $p < .001$).[51]

<figure 2 near here>

Indeed, democratic governments in the low-expectations prewar period generally implemented policy responses that adhered closely to the Bagehot ideal-type. The average response remains below zero for nearly all of the pre-1945 period. In years with a relatively large number of new crises, as in the early 1920s and the 1930s, policy responses tend towards the Bagehot end of our index. Of the three policies our analysis suggests to be most strongly identifiable with a coherent Bailout response, we observe only one prewar case of deposit insurance (the United States in the Great Depression) and one instance where the government assumed responsibility for non-performing bank assets (Germany in the final years of the Weimar Republic), and only a third of the cases employed recapitalizations.

The rising tendency towards Bailout interventions from the mid-1970s, especially since the 1990s, is consistent with our argument that the protection of household wealth became an increasingly important objective of governments in this period. We observe a striking reversal of prewar policy trends after the 1970s, most notably with respect to government protection of deposits and use of the public-sector balance sheet to recapitalize banks and to assume responsibility for bad assets and debts. These defining features of Bailout interventions respectively feature in more than 70 per cent, 66 per cent and 53 per cent of post-1970 systemic crises in democracies.

We do not deny that ‘capture from above’ by concentrated financial and related interests will in some cases shape policy outcomes. However, since the degree of such capture can vary substantially across countries and because, as noted above, there is

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attributable to suffrage expansion and democratization. See: http://www.systemicpeace.org/polityproject.html.

[51] In systemic crises after the 1990s the average response rises to 1.17 and the difference from the pre-war period increases in statistical significance ($t = 9.53$, $p < .001$).

no strong reason to assume that it was far lower in the prewar era, it is unlikely that this explains the broad historical trend we identify. Examining evidence from the United States alone, a number of authors point to the growing importance of money in politics and the influence of the financial sector specifically on policy outcomes.[52] Yet we see similar bailout responses in recent crises in countries where the role of private money is far more restricted than in the United States.[53] The same is true for a number of advanced democracies that vary greatly on 'structural power' dimensions of potential elite financial capture, such as the size, degree of internationalization, concentration and tax contributions of the financial sector.[54]

The rising importance of the use of the public-sector balance sheet in policy responses to systemic crises also implies that adequate state fiscal capacity could be a necessary condition for this shift. This is probably an important reason why, as figure 2 indicates, Bagehot responses persisted until the early 1990s. Most systemic crises in democracies until the 1990s occurred in poorer countries with relatively low levels of financialization, fiscal capacity or policy space (owing to to IMF conditionality) to pursue bailouts. Indeed, all the Bagehot responses in this period—of which there are twelve—occurred in developing countries. Nine of these countries were under IMF programmes at some point during the crisis window, and five had large public debt burdens above 70 per cent of GDP. From the 1990s, when systemic crises became

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[52] Larry M. Bartels, *Unequal democracy: the political economy of the new gilded age* (New York: Russell Sage Foundation; Princeton: Princeton University Press, 2008); Adam Bonica, Nolan McCarty, Keith T. Poole and Howard Rosenthal, 'Why hasn't democracy slowed rising inequality?,' *Journal of Economic Perspectives* 27: 3, 2013, pp. 103–24; Hacker and Pierson, *Winner-take-all politics*; Johnson and Kwak, *13 bankers*; Atif Mian, Amir Sufi and Francesco Trebbi, 'The political economy of the subprime mortgage credit expansion', *Quarterly Journal of Political Science* 8: 4, 2013, pp. 373–408.

[53] The International Institute for Democracy and Electoral Assistance (IDEA) provides comparative data on restrictions on private money in campaign finance: http://www.idea.int/data-tools/data/political-finance-database.

[54] For an analysis of how such differences can matter in other respects, see Culpepper and Reinke, 'Structural power and bank bailouts'.

more concentrated in developed countries, where financialization is higher and fiscal capacity is less of a constraint, there was a marked trend towards Bailout responses.[55] This finding underlines the hypocrisy of advanced countries' insistence on market-conforming policies in developing-country crises.

By restricting our analysis to deep and costly systemic crises, we are able largely to rule out economic consequences alone as responsible for the rising tendency we observe. Prewar crises were often just as destructive as those in the postwar era, sometimes more so. Yet societal expectations were much more restrained at this time, and governments responded to crises with less sweeping interventions. Since the 1970s, the comparative size and influence of the Bailout constituency appears to have overwhelmed those constituencies favouring more limited, Bagehot-style policy responses.

Political survival after banking crises

Our primary interest in this section is to assess whether and, if so, how banking crises affect the hold of political incumbents on office. We constructed a new dataset of 499 elections between 1872 and 2015 for 33 democracies in our sample. We considered only elections for the chief executive (e.g. presidential elections in the United States; parliamentary elections in Japan), focusing on the vote share of the president's party in presidential systems and that of the governing party or dominant party in the governing coalition in parliamentary systems.

From our full sample, we observe that 96 terms of office—19.3 per cent of the total—experienced a crisis. The prewar sample contains 175 terms of office, of which 29.0 per cent (50) experienced a crisis. The post-1970 period yields 324 terms of office, of which 14.2 per cent (46) faced a crisis.

[55] Note too that fiscal capacity may not have been lower for advanced countries in the pre-1945 era. See Paolo Mauro, Rafael Romeu, Ariel Binder and Assad Zaman, *A modern history of fiscal prudence and profligacy*, IMF Working Paper 13/5 (Washington DC, 2013).

To assess whether veto players condition the effect of banking crises on incumbent party vote share, we use the Political Constraints Index Dataset.[56] Based on a simple spatial model of political interaction, this index captures the number of independent actors with veto power and the distribution of political preferences across those actors. It ranges from 0 to 1, with higher values indicating a greater number of veto players with distinct political preferences. We plot the results from a series of difference-in-means tests that compare incumbent vote share change following crisis-afflicted and crisis-free ('tranquil') terms of office, and include 95 per cent confidence intervals (figure 3).

<figure 3 near here>

Our first main finding is that voters are much more inclined to punish incumbents following a banking crisis after 1970 than before that date. We failed to uncover a strong or statistically significant post-crisis punishment tendency in the low expectations prewar era. We observe significantly greater electoral punishment in the aftermath of a crisis in the all-periods sample. When compared to tranquil terms of office, incumbents presiding over a crisis suffer a negative vote swing of nearly 3 per cent more in the following elections.

Yet, crucially, we observe that this effect is confined to the post-1970 period. Here, when compared to tranquil terms of office, the negative vote swing for incumbents is over 5 per cent higher in elections following a banking crisis. In sharp contrast, in the prewar era, incumbents did not experience a comparable electoral fate: the difference between tranquil and crisis-afflicted terms of office is not statistically distinguishable from zero. Crises appear not to be very salient for prewar voters, consistent with our argument that lower expectations regarding policy responsibility then prevailed. We also note that in our statistical tests we considered restrictions on suffrage, but find that these are not a decisive factor shaping our results.

This finding can be illustrated with reference to the banking crises of 1907 in the United States and Canada, where incumbent parties had been in power for nearly a

[56] Witold Henisz, POLCON Database, https://whartonmgmt.wufoo.com/forms/political-constraint-index-polcon-dataset/, 2013.

decade. Government policy responses were very limited, including in the United States where the crisis was more virulent.[57] Sharp recessions ensued in 1908, when GDP fell by 4.7 per cent in Canada and 8.2 per cent in the United States. Despite this, neither incumbent political party lost power in the elections held that year in both countries.

After 1970, incumbent governments suffered much harsher verdicts from voters following a crisis. Electoral losses were particularly pronounced during the crises of the 1980s in Latin America and in western democracies after 2008. In the 1980s, incumbent parties in Argentina (1989), Bolivia (1989), Colombia (1982 and 1986), Uruguay (1989) and Venezuela (1982) saw their vote share plummet after presiding over banking crises and debt problems. In the 1985 election in Peru the incumbent Popular Action Party experienced the sharpest decline recorded during this period, with a negative vote share swing of nearly 37 per cent.

In the aftermath of the 2007–2008 crisis, incumbents saw their vote share fall in Austria, Belgium, France, Greece, Ireland, the Netherlands, Portugal, Spain, the United Kingdom and the United States. By far the largest collapse of electoral support was observed in the 2011 election in Ireland, where the governing party Fianna Fáil lost office when its vote share fell from 41.6 per cent in 2007 to 17.4 per cent. Spain's Socialist Party suffered a 15.5 per cent negative swing and loss of office in the 2011 election, the worst result for a sitting government in that country since 1982.

Our second main finding is that such electoral punishment is strongest in democracies with more polarized veto players. In low veto player environments, by contrast, we found no significant decrease in the incumbent vote share after a banking crisis. These findings are once again confined to the post-1970 period.[58]

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[57] The United States had no central bank at this time and the private sector, led by J. Pierpont Morgan, undertook modest stabilization. See Robert F. Bruner and Sean D. Carr, *The panic of 1907: lessons learned from the market's perfect storm* (Hoboken, NJ: Wiley, 2007). The private sector led a similar effort in Canada: see Conant, *A history of modern banks of issue*, 5th edn, pp. 469–71.

[58] This is also consistent with the finding in Crespo-Tenorio et al., 'Political liabilities'.

Figures 4 and 5 show the results for incumbent parties and coalitions, respectively. Here we compare changes in incumbent vote shares in crisis and crisis-free terms in both ‘high’ and ‘low’ veto player environments (defined respectively as one standard deviation above and below the sample mean).

<figures 4 and 5 near here>

In the full sample, when comparing incumbents in high veto player environments, we found that those presiding over a banking crisis lose on average more than 5 per cent more of their vote share than their crisis-free peers. We find no such significant difference in low veto player environments. The veto player environment thus appears to condition the impact of banking crises on political incumbents’ hold on office, in ways that are inconsistent with the clarity of responsibility hypothesis.

Further investigation reveals that this impact is again confined to the post-1970 era. Figures 4 and 5 reveal a notable shift in the reaction of voters to crises across different veto player environments since 1870. In the modern era, the negative vote share swing for incumbents in high veto player environments is more than 12 per cent higher following a crisis than in crisis-free terms. In low veto player environments, we find no significant differences between crisis-afflicted and crisis-free terms. In addition, we see no similar significant asymmetric effect across different veto player environments in the prewar period.

Why did these institutional variations across democracies become so much more important after 1970? The most plausible explanation is that governments that face more political constraints in a severe banking crisis are less able to deliver the decisive intervention that many voters now demand. Substantially higher levels of financialization and leverage have also made governing in the wake of crises much more difficult and contentious.[59] In such circumstances, greater policy contestation may have increased the likelihood that institutional vetoes will be used to block decisive interventions. In addition, higher inequality, often visibly associated with financialization, may have exacerbated political polarization and increased the importance of institutional vetoes. Inequality may also be further increased by costly interventions that require later reductions in welfare spending, emphasizing their

[59] Funke et al., ‘Going to extremes’.

negative distributional consequences for many voters.[60] Government attempts to meet society's great expectations are thus fraught with risk.

This point can be illustrated by the contrasting responses and electoral fates of incumbent centre-right parties in the United States and Sweden following the recent financial crisis. Bermeo and Pontusson conclude that in the United States, elite political polarization and supermajoritarian features of the political system 'profoundly shaped (and hampered)' the policy response after January 2008.[61] Congressional delay in approving the Bush administration's Troubled Asset Relief Program (TARP) in September 2008 was one consequence, as was the absence of bipartisan agreement on substantive action on household mortgage modifications. The policy interventions that were agreed appeared to many voters selective and highly redistributive, bailing out large banks while leaving millions of American families subject to foreclosures and employment losses.[62] In Sweden, despite a higher number of potential vetoes, 'elite consensus facilitated a swift and effective crisis response'. There, the stimulus packages adopted by the centre-right Alliance government in 2008 and 2009 were relatively uncontested.[63] Whereas the US Republicans were heavily defeated in the 2008 presidential elections, in 2010 Swedish voters returned the Alliance to power with an increased vote share—the first time a centre-right Swedish government had achieved this in almost a century.

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[60] Atkinson and Morelli, *Economic crises and inequality*; Mian et al., 'Resolving debt overhang'.

[61] Nancy Gina Bermeo and Jonas Pontusson, eds, *Coping with crisis: government reactions to the Great Recession* (New York: Russell Sage Foundation, 2012), p. 15.

[62] Neil M. Barofsky, *Bailout: an inside account of how Washington abandoned Main Street while rescuing Wall Street* (New York: Free Press, 2012), pp. 127, 196–200; Bethany McLean and Joseph Nocera, *All the devils are here: unmasking the men who bankrupted the world* (London: Portfolio, 2011).

[63] Johannes Lindvall, 'Politics and policies in two economic crises: The Nordic countries', in Bermeo and Pontusson, *Coping with crisis,* pp. 233-260.

Conclusion

We have provided evidence to support our argument that the rise of societal expectations regarding financial stabilization over the past century has had powerful consequences for both economic policy and political survival. Although we do not deny that financialization is associated with the increased influence of financial sector interests over politics and policy, our argument identifies and emphasizes a different political mechanism. Rather than 'elite capture', our theory suggests instead that rising demand for the protection of incomes and accumulated wealth by the middle classes—'mass capture'—has been a powerful force behind financialization, rising financial instability, government bailouts of large financial firms and asset markets, and political turnover since the 1970s. Elite capture is unlikely to explain trends common to a variety of democracies over such a long period. Indeed, it is only by stepping back and taking a long-run perspective that we can see the powerful impact of these changing mass societal expectations on politics and policy.[64]

What are the broader consequences of these developments? Over the long run, changing policy responses have probably altered the way that actors behave, including their propensity to take on risk. This has in turn helped to reshape both the financial system (including its degree of fragility) and the political system.

As the scope of great expectations has expanded, elected governments face a growing number of policy dilemmas, including trade-offs between objectives of financial stabilization and of growth. On the one hand, if governments try to promote growth via financial liberalization, this poses persistent risks to accumulated wealth through cycles of asset price booms and busts. On the other hand, if they seek to achieve financial stability through extensive financial repression, this risks suppressing growth, incomes, employment and wealth.

Since electoral cycles are usually shorter than financial cycles, we believe that financial repression is politically unsustainable over the long run. The economic and political importance of the financial sector and associated interests also inhibits any

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[64] Seabrooke, 'The everyday social sources of economic crises'; Leonard Seabrooke, *The social sources of financial power: domestic legitimacy and international financial orders* (Ithaca, NY: Cornell University Press, 2006).

return to extensive financial repression. The pattern of modern debate on financial re-regulation after major banking crises is instead for early radical calls for much more stringent regulation to be displaced by arguments that this would impose too great a hindrance on growth. The debate since 2008 has been no exception, so that the most likely outcome will be a modest increase in financial regulatory stringency and a continuation of the processes of financialization and rising leverage that have characterized the post-1970 era.

This tendency may have encouraged long-term financial instability, partly because liberalized and complex finance creates extensive opportunities for innovative actors to gain competitive advantage by arbitraging regulation,[65] and also because rising societal pressure for bailouts when crises occur has encouraged governments to underwrite past decisions by actors to take on greater risk and leverage. Paradoxically, then, the rise of great expectations has helped to reinforce the very threat to financial stability that citizens and governments fear.

This suggests a political interpretation of the 'Minskian' cycle of credit boom and bust. Citizens and firms are unwilling to forgo the perceived benefits of financialization and leverage on the assumption that governments will intervene to underwrite the financial system and protect their assets when periodic crises occur. But this increases financial fragility and the probability of future crises. 'Policy success', in such circumstances, may consist in governments getting through electoral terms without experiencing costly crises; or, failing that, undertaking crisis interventions that restore the functioning of the financial system at substantial public cost, followed by recession and austerity.

What are the implications for everyday politics? If financialization, leverage, crises and interventions are endemic, distributional conflict will remain acute. To the extent

[65] Hyman P. Minsky, *The financial instability hypothesis*, Economics Working Paper Archive (Annandale on Hudson, NY: Levy Economics Institute, 1992); Andrew G. Haldane, *Turning the red tape tide* (London: Bank of England, April 2013); Adair Turner, *Between debt and the devil: money, credit, and fixing global finance* (Princeton: Princeton University Press, 2015).

that this is partly responsible for increasing political polarization and mistrust of government, this implies continuing challenges for democratic politics.

The pressure of great expectations has also eroded traditional right-wing support on principle for more market-conforming policies. An illustration is provided by the George W. Bush administration's reversal of its earlier opposition to using public funds to recapitalize banks after the collapse of Lehman Brothers in September 2008. 'Government owning a stake in any private US company', Hank Paulson, then Treasury Secretary, explained, 'is objectionable to most Americans—me included. Yet the alternative of leaving businesses and consumers without access to financing is totally unacceptable.'[66] Other examples of right and centre-right governments intervening extensively in 2008–2009 include those of the Christian Democrats in the Netherlands, Venstre in Denmark, Fianna Fáil in Ireland and the Independence Party in Iceland.

Centre-left and left-wing governments that historically baulked at the prospect of rescuing large banks during crises have similarly had to succumb. Prominent recent examples include the governments of the Labour Party under Gordon Brown in the United Kingdom, the Social Democratic Party in Austria and the Socialist Workers' Party in Spain. Left and centre-left political parties represented in European coalition governments that provided extensive financial sector bailouts have included the German Social Democratic Party and Luxembourg's Socialist Workers' Party.

This combination of crises, financialization and bailouts may pose particular political challenges to left-wing political parties, further eroding their support base over the longer run. In addition to the ideological strain produced by left and centre-left parties undertaking bailouts and adopting post-crisis austerity policies, as financialization and leverage grow their redistributive effects may increase over time, contributing to relatively greater losses for low-income voters.[67] This could increase these voters'

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[66] As quoted in Edmund L. Andrews and Mark Lander, 'White House overhauling rescue plan', *New York Times*, 11 Oct. 2008.

[67] Atif Mian and Amir Sufi, *House of debt: how they (and you) caused the Great Recession, and how we can prevent it from happening again* (Chicago: University of Chicago Press, 2014); Rajan, *Fault lines*.

propensity to defect from such parties and may help to explain why far-right parties tend to be the biggest political beneficiaries of banking crises.[68]

Finally, we may ask: is it better to be in government or in opposition when crises hit? As we have argued, banking crises provide a gift to opposition parties, which can blame their occurrence on incumbents and portray interventions as delayed, unfair, misjudged and/or inadequate. In single-party government systems, then, being in opposition at this point has unambiguous advantages, as Britain's Conservative Party demonstrated over 2008–2010. Uruguay's systemic crisis in 2002 provides a less well-known case of opposition strategy in a high veto player environment. When the crisis struck, the opposition centre-left Frente Amplio (FA: the 'Broad Front') played the role of 'loyal opposition' in passing emergency legislation that was a condition for securing a loan from the United States that helped to stabilize the banking system in the face of an 11 per cent collapse in output.[69] By the time of the 2004 election, Uruguay's economy was experiencing a strong recovery. The FA's strategy of collaboration and limited dissent enabled it to claim some credit for the country's stabilization while pointing to the traditional ruling parties' responsibility for the crisis. The election result—a monumental swing of 43.5 per cent away from the incumbent party—brought the FA to power in Uruguay's first government not composed by one of two traditional leading parties.

The second-worst position, after that of the incumbent in a single-party government, is probably that of a potential opposition party in a coalition government. As the German Social Democratic Party (SPD) found to its cost in 2010, being in government as a minority partner when the crisis hit and supporting interventions in the same manner as Uruguay's FA robbed it of the ability to shift blame to Angela Merkel's Christian Democrats. In the end, however, both governments and opposition parties must make the best of their circumstances when crises occur. In an age of financial fragility and great expectations, in which new movements are sweeping

[68] Funke et al., 'Going to extremes'

[69] Francisco Panizza, '"Everybody out," "we are fantastic:" the politics of financial crises in Argentina and Uruguay 2001–2003', in Francisco Panizza and George Philip, eds, *Moments of truth: the politics of financial crises in comparative perspective* (London: Routledge, 2014), pp. 27–46.

aside political party systems that have been stable for decades, no political party can be fully secure.

Figure 1: Real net private wealth per capita, selected countries 1870-2014, constant 2015 US dollars and PPP exchange rates. Source: www.WID.world, accessed 6 March 2017.

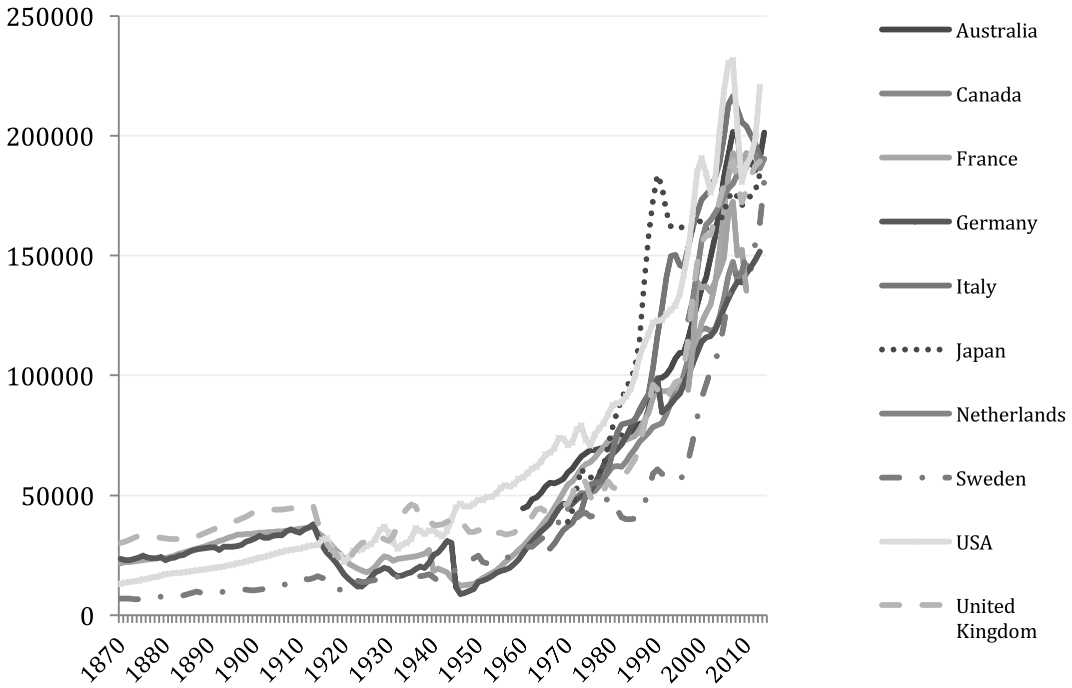

Figure 2: Average Policy Response Index for R&R Systemic Banking Crises in Democracies, 1848 – 2010.

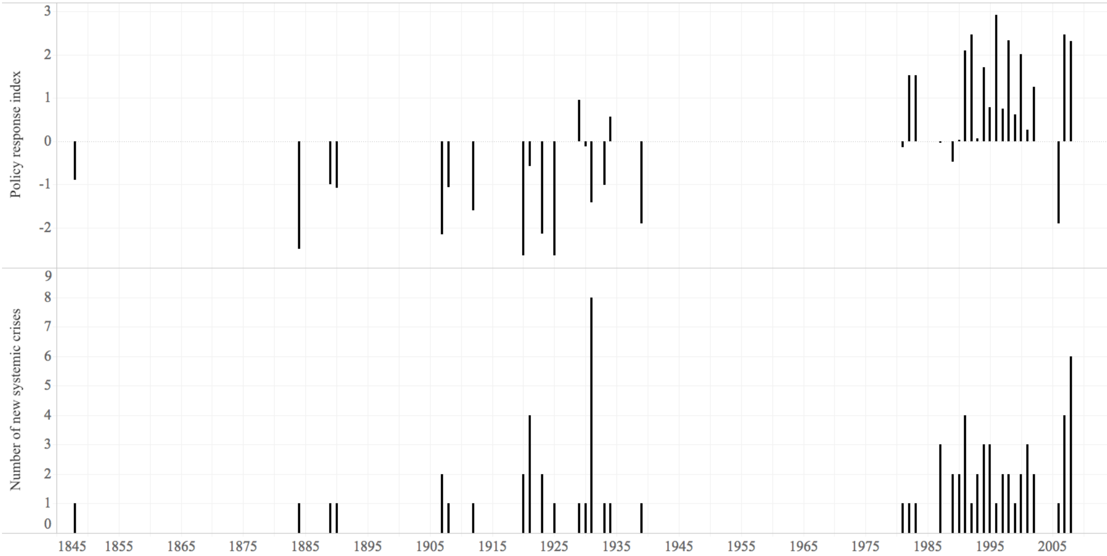

Figure 3: Systemic Banking Crises and Changes in Incumbent Vote Share, 1872 - 2015.

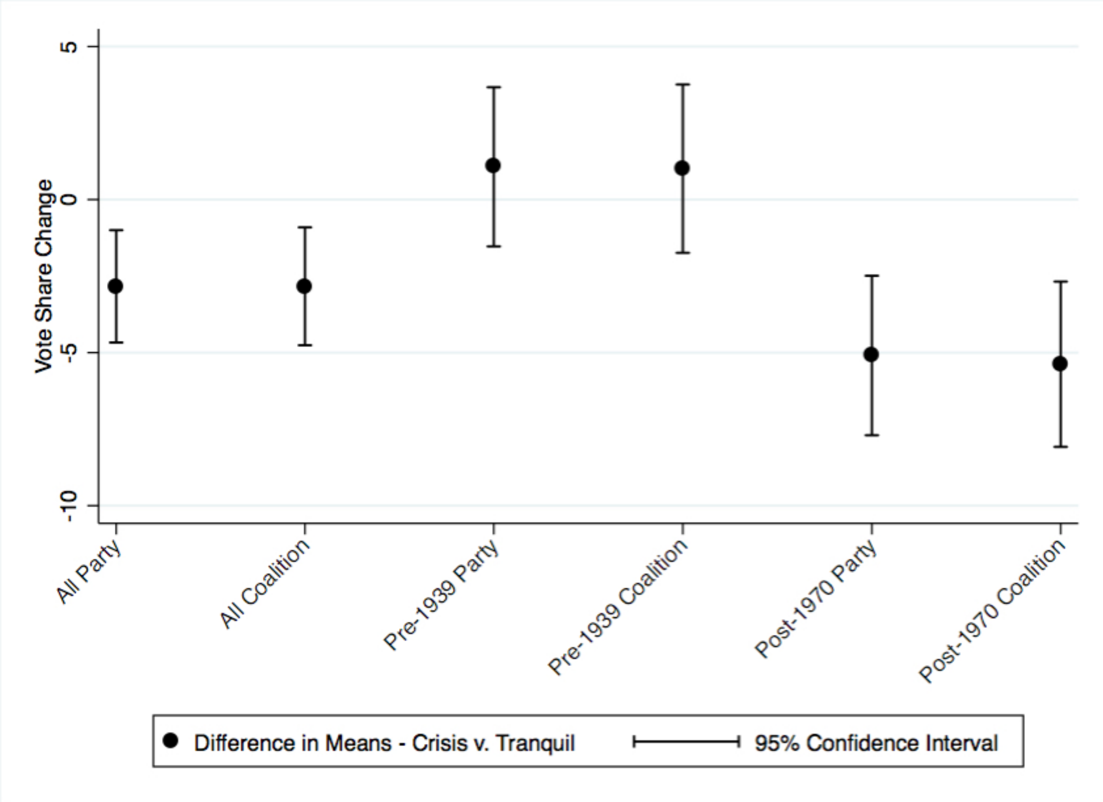

Figure 4: Banking Crises and Changes in Incumbent Party Vote Share Across Veto Player Environments, 1872 - 2015.

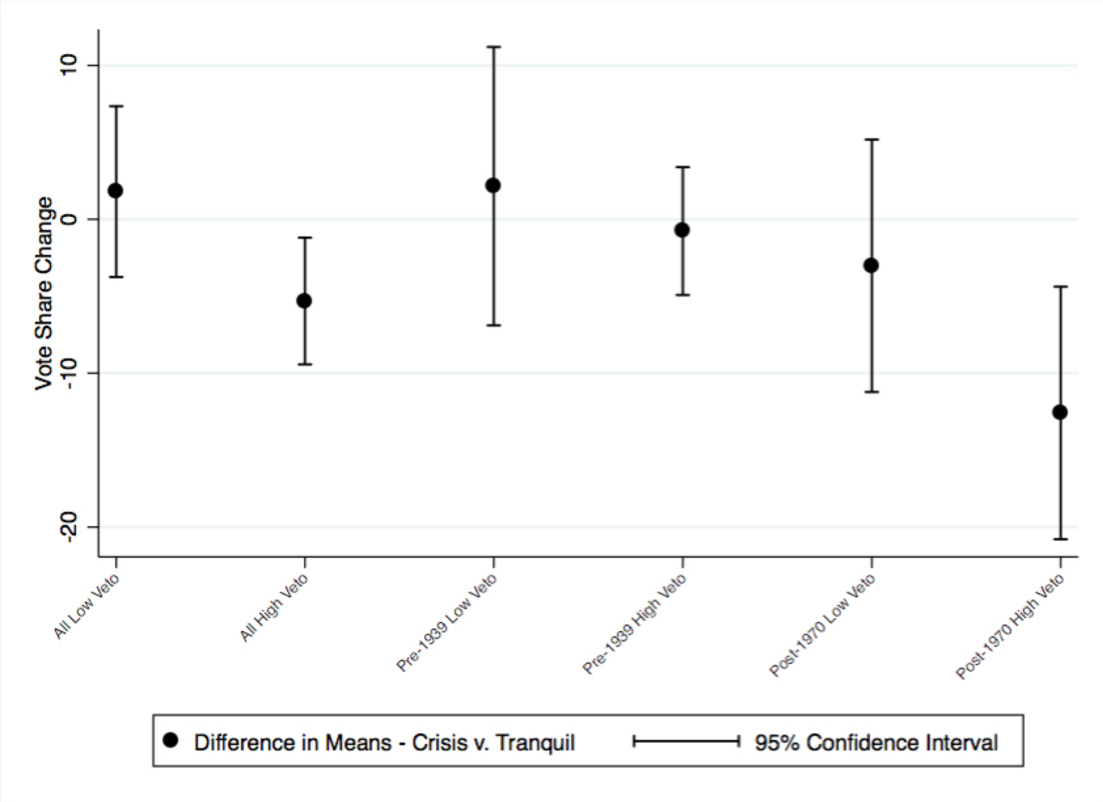

Figure 5: Banking Crises and Changes in Incumbent Coalition Vote Share Across Veto Player Environments, 1872 - 2015.